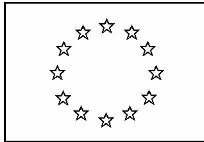

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2002 UPDATE

OF THE CONVERGENCE PROGRAMME OF FINLAND

(2002-2006)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

The November 2002 update of the Finnish stability programme foresees a marked acceleration of GDP growth to 2.8% in 2003, nearly a double of the growth rate of 1.6% in 2002. Between 2004 and 2006, growth should remain close to its trend rate of about 2¾ %. Consequently, output gap is seen to fade in later years of the programme period, following a gap of over 2% in 2001 due to exceptional growth of 2000. This fourth update of stability programme assumes, up to 2003, a broadly similar profile of output projections as the previous programme, from whereon growth is seen more strongly constrained by labour supply compared with the earlier programme. Growth contributions from different demand components have been modified somewhat, as the external contribution appears stronger in the current programme whereas support from domestic demand is slightly weaker. In 2002, employment creation has been relatively resilient to the previous slowdown in activity. However, a slight pick-up in unemployment has been noted in the course of the year and although growth is projected to accelerate, a rise in the unemployment rate is projected for both 2002 and 2003. Inflation is expected to decelerate to 2% by 2003 in the absence of external shocks, while a more marked decline is projected for 2004.[1] Subsequently, inflation is expected to resume its earlier trend of about 2%. Apart from a weaker growth estimate for 2004, the programme's short-term projections compare reasonably well with the Commission Autumn 2002 forecast.

The updated programme foresees a significant decline in the general government surplus from 4.9% of GDP in 2001 to just over 2% in 2004, in spite of solid output expansion. This owes partly to income tax cuts which exceed the initial government target for 2000-03 and partly to revenue loss due to erosion in tax base and increased tax competition. In subsequent years, the surplus is expected to resume an upward trend and rise to close to 3% by 2006. Notwithstanding similar growth projections, the current update projects a higher government surplus than its predecessor, notably for 2002, owing to more buoyant revenue intake from corporate taxes. In 2004, however, the surplus is now set to diminish more markedly, owing to revenue shortfalls. Nevertheless, the projected path of the government balance shows that public finances in Finland remain clearly in line with the requirements of the Stability and Growth Pact throughout the programme period. The biggest contribution to the falling surplus ratio comes from the deterioration of central government finances which are estimated to even slip into deficit as from 2004. As a result, the government's aim of achieving a structural surplus in central government finances of 1½-2% of GDP in the medium term appears to be moving further away. Furthermore, the local government financial balance seems to resume its customary deficit in 2003. In fact, according to the programme, general government financial surplus in 2004-06 rests solely on the surplus of the social security funds and, moreover, on that of the earnings-related pension funds preparing for financial pressures stemming from an ageing population. Moreover, the projected decline in the cyclically adjusted balance by 1½ percentage points of GDP between 2002-04 seems to come at the time when the economy should be strongly gathering momentum, implying, thus, a pro-cyclical stance of fiscal policy. Still, according to the programme, the cyclically adjusted budgetary surplus should remain at 2% of GDP, or higher, throughout the programme period. This should still

[1] Also due to the end of the transition period for free import of alcohol and tobacco from other EU countries amounting to a estimated loss of tax revenue amounting to close to 1 % of GDP.

leave enough leeway against any normal fluctuations in activity, although underlying surplus is forecast to fall by 1¾ percentage points of GDP between 2002 and 2004.

The current programme projects general government debt to fall at a somewhat faster pace between 2002 and 2003 than the previous programme, although the initial position was less favourable than targeted in 2001. Indeed, unlike in the previous programme, a rise in the debt ratio is no longer expected, owing also to a slightly higher nominal GDP estimate. On the other hand, the estimated 2.7 pp. of GDP decline in the debt ratio from 43.4% at end-2001 to 40.7% at end-2006 appears modest given the high primary surpluses of general government finances over the programme period and in view of the assumption of stable additional revenues from privatisation. According to the programme, the stickiness of debt reduction is due in particular to financial transactions: to the ongoing diversification of social security institutions' assets away from central government bonds and to the accumulation of earnings-related pension fund assets of the central government. It cannot be excluded, however, given the amount of government debt held by the sector, that the shift in pension fund portfolio might be faster[2] than expected in the programme[3], and the fall of gross debt ratio could slow down even stronger over the period.

The government programme included a plan to cut income taxes by some € 1.7-1.8 billion during its term with a view to boosting employment creation, but also shifting taxation towards capital and environmental taxes. According to the update and including the latest amendment to the 2003 budget proposal, income tax cuts are estimated to amount to some € 2½ billion between 1999 and 2003, exceeding the original target of government programme by about ½ % of GDP. The cuts can be justified against the background of the earlier healthy budgetary position and a high overall tax burden on labour. Moreover, they seem to be accompanied by adhering to tight spending ceilings in the central government finances in 2003. On the other hand, they appear relatively modest with regard to the intended boost in labour demand, even more so, as the rise in local government tax rates will largely offset the tax relief, contributing to a fairly neutral stance of earnings taxation in 2003. Had there been tight spending freezes in 2001-02, the government would have afforded higher income tax cuts. Altogether, the tax burden is foreseen to fall by a total of €2.8 billion during the four-year term of the current government.

The update foresees general government expenditure to fall from 47.5% in 2002 to 46.1% in 2006 (although the expenditure ratio is seen 0.7 percentage points higher for 2004 than in the previous programme), due to lower interest payments on debt but, more importantly, on the back of tight budgetary policy. Tight expenditure control has also been the key fiscal policy tool of the current government, but the earlier target of freezing central government spending at the level of 1999 appears out of reach. According to the update, central government expenditure, excluding interest payments, is estimated to have increased at an average annual rate of about 2% in real terms during the term of the current government and be left in 2003 at € 1 billion higher in real terms than the level in 1999. The overrun was particularly evident in 2002, although part of it follows from changes in accounting practices, but there was a

[2] 55% of all employment fund investments were invested outside Finland in the third quarter of 2002 while the share was 41.2% in the beginning of 2001.

[3] The employment pension funds are assumed to reduce their investments in central government assets by €1.0 billion in 2002, by €0.5 billion in 2003 and by €0.3 billion in 2004 to 2006.

slippage already in 2001. Thus, the commitment of carrying out the expenditure control seems to be postponed to the next government to be elected in early 2003. It should be remembered at this point, that in the 2002 Broad Economic Policy Guidelines (BEPG) and in last year's assessment of the stability programme, the Council recommended to firmly adhere to the spending ceilings in coming years and that some of the lost ground is regained in the Spring 2002 review of the spending ceilings. To this end, the 2003 budget appears promising since the central government expenditure is forecast to be limited at the level of spending ceilings agreed in March 2002.

The programme presents various measures to improve the financial balance of local governments[4]. These are clearly a step in the right direction, in particular with respect to strengthening the predictability of local government finances. Still, the recently adopted legislation requires municipalities to maintain a balance in their finances over a three-year planning period. According to the programme, local government finances are expected to show deficit over a period of 2003-06. Therefore, the government needs to further enhance the implementation of the legislation through, as recommended also by the 2002 BEPGs, carefully monitoring[5] municipal finances. In addition, in view of the increasing unemployment, various active labour market policy measures of the programme should help to alleviate the problem of high unemployment in Finland.

The 2002 updated programme contains a detailed section on the sustainability of public finances, completed with national budgetary projections for public expenditures and revenues up to 2050. They show that age-related expenditures are projected to increase by some 6 percentage points of GDP between 2005 and 2050: revenues are also projected to increase by some 2 percentage points of GDP over the same period. Consequently, public finances in Finland are in good position to meet the budgetary consequences of ageing populations. This is largely due to the sustained running of a budget surplus which is leading to a fast pace of debt reduction in the long term. Even though the budget surplus is set to decline somewhat over the programme period, over the coming two decades gross debt will continue to fall rapidly, as a result of an explicit policy goal. In addition, the sustainability of public finances is supported by a pension system that is to a large extent pre-funded[6]. The recent reforms[7] of pension and unemployment insurance systems, encouraged also by the 2002 BEPGs, should help to restrain the long-term expenditure pressures[8]. Some of the results, however, seem to emerge with a considerable lag. The most immediate challenge will be to finalise the reforms of the pension systems according to the time frame indicated in the programme. A longer term challenge may stem from the fact that the projected sustainability of public finances is based on an assumption of a tax ratio of some 50% of GDP in coming decades. However, the projected tax ratio is high relative to other industrialised countries and the desirability of maintaining such high tax ratios over the

[4] Revenue in local government has been made less sensitive to cyclical fluctuations and better budget monitoring is being developed.

[5] Local governments are administratively fairly independent in Finland.

[6] The market value of statutory earnings-related pension funds was some 51% of GDP in 2001.

[7] E.g. termination of certain early-retirement schemes, incentives to encourage older workers to remain in the labour force and mechanisms to adjust pension entitlements in line with changes in life expectancy.

[8] Still, further steps are planned, *inter alia* dealing with pension systems in the public sector.

very long-run could be called into question by the increasing mobility of production factors (and consequently tax bases) increases in light of globalisation.

1 INTRODUCTION

The government on 28 November 2002 approved Finland's updated stability programme. This is the fourth annual update of the programme presented originally in September 1998. Last year's update covered the period up to 2004. It was assessed by the Commission and by the Economic and Financial Committee, and the Council gave its opinion on 6 February 2002[9].

The current update covers the period 2002-2006. Up until 2003, its macro-economic scenario is based on the November 2002 forecast by the Ministry of Finance, which deviates from the macro-economic assumptions underlying the government's 2003 budget proposal presented on September 17th 2002. As a consequence, the public finance projections of the programme for the year 2003 differ somewhat from those included in the budget proposal. Beyond 2003, the programme uses projections based on the longer-term growth potential.

According to the updated programme, the Finnish government maintains the objective of improving the fundamentals for environmentally sustainable economic growth and ensuring the competitiveness of the operating environment for entrepreneurship. Regarding budgetary strategies, this is considered to be best achieved through strong public finances fostering economic stability as well as growth. In particular, securing structural surpluses in central government finances and reducing the public debt are measures which are expected to give the necessary room for manoeuvre to deal with both cyclical fluctuations and future age-related expenditure pressures. In line with this strategy, central government finances are targeted to be in surplus amounting to between 1½% and 2% of GDP over the medium term. This should be achieved, primarily, by keeping real expenditure net of debt redemption at the level of 1999. Furthermore, privatisation proceeds are to be allocated primarily to redeem state debt and to safeguard the existing level of R&D funding.

The 2002 update of the stability programme is in line with the Code of Conduct endorsed by the Council[10]. The programme presents, in particular, a long-term analysis of issues related to the ageing of the population. The programme covers extensively the government's budgetary policy strategy in this regard. Moreover, the programme presents enhanced measures to bring down structural unemployment and to promote employment, which, in relation to the labour force has been falling short of the government's target of close to 70%. Regarding the government's aim of shifting taxation from income towards environmental taxes, the programme presents first

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[9] The Council Opinion on Finland's updated Stability Programme was published in the *Official Journal* C 33 of 6.2.2002.

[10] On 10 July 2001 the ECOFIN Council endorsed the Opinion of the Economic and Financial Committee and the Code of Conduct on the content and format of the Stability and Convergence Programmes.

steps[11]. In addition, the programme claims that budgetary monitoring of the local governments is being improved in order to ensure that municipalities will meet their obligation of maintaining a close to balance financial position within a three-year period. However, no details of these monitoring plans are presented in the programme.

On the 2001 update of the stability programme the Council noted that the Finnish general government surplus was projected to remain at fairly high level throughout the period 2001-04. The 2002 update sees the general government financial position broadly unchanged (see table 2. of this note), but expects the surplus in 2004 to fall short of the target in the previous programme. This seems to follow mainly from shortfalls of tax revenue against previous programme projections. This, in turn, appears to be leaving general government debt in 2004 marginally higher in relation to GDP compared with the target in the previous programme. The updated programme largely adheres to the budgetary policy recommendations by the Council in the Broad Economic Policy Guidelines (BEPGs) of 2002, although some additional effort is needed in the areas of central government spending control and monitoring of local government finances.

2 IMPLEMENTATION OF THE PREVIOUS UPDATE

Output growth decelerated strongly in 2001, much as predicted in the stability programme update of November 2001, posting a modest 0.7% and following an average rate of growth of well over 4% during the second half of the 1990`s. This was mainly due to a severe external shock. For the first time in 12 years, net external demand held back GDP growth in 2001. Domestic demand held up better. General government finances showed surplus of 4.9% of GDP[12], i.e. 0.2 percentage points higher than predicted in the 2001 update of the stability programme, owing to slightly higher tax revenues and higher social security contributions. In spite of a higher than expected surplus, the debt to GDP ratio turned out to be markedly higher than projected in the previous programme, by 0.7 percentage points of GDP at 43.4% of GDP, due mainly to net accumulation of financial assets and the ongoing diversification of social security institutions' assets away from domestic government bonds. A comparison with the previous update is given in table 2 of this note.

GDP in 2002 is expected to have grown by about 1½ %, in line with the estimate of the previous update. Final domestic demand is expected to have maintained its growth-supportive role although investment is estimated to have decreased. Somewhat unexpectedly, however, net exports seem to have made a positive growth contribution. Owing partly to the exceptionally high corporate and capital tax revenues of 2000-01 returning to normal, the general government surplus is estimated to have declined by over 1 percentage point of GDP in 2002. Still, the expected surplus of 3.8% of GDP exceeds the target set in the previous programme by over 1 pp. of GDP. The government gross debt ratio is estimated to have fallen to 42½ %. This is some 0.4

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[11] The 2003 Budget includes rises in taxes on liquid fuels, electricity, coal, natural gas and peat by about 5%. In addition, several municipalities plan to raise municipal taxes and taxes on immobile property in 2003.

[12] General government surplus reached 7.0% of GDP in 2000 owing mainly to buoyant corporate and capital tax revenues.

percentage points of GDP lower than targeted in the previous programme and is partly due to higher privatisation proceeds, and partly to higher than expected nominal GDP.

The GDP growth estimate of 2.8% for 2003 is virtually unchanged from the previous programme although growth seems to lean more towards the external demand component. The government surplus, on the other hand, is estimated at 2.7% of GDP, i.e. ½ percentage point higher than previously targeted. This is due to higher tax revenues now expected. Moreover, debt should fall to 41.9% of GDP, 1 percentage point below the target of the previous programme, owing mainly to a higher primary surplus. In 2004, at 2.6%, GDP growth is expected to fall short of last programme's projection by 0.4 percentage points owing to weaker final domestic demand, in particular for investment. In 2004, inflation will face a domestic shock as the transition period towards free import of alcohol and tobacco from other EU countries ends. Subsequently, due mainly to likely changes in the excise duties for alcoholic beverages and tobacco, inflation is expected to ease to 1%, i.e. over ½ percentage points above the target of the previous update. The general government balance in 2004 is estimated to fall short of the target of the previous programme by ½ percentage point of GDP, due mostly to central government finances turning into deficit. It should still reach a surplus of 2.1 % of GDP. At 41.9% of GDP, the general government gross debt ratio is projected to remain at the level of 2003 meeting roughly the target set in the previous programme.

3 MACROECONOMIC ASSESSMENT

3.1 External economic assumptions

The macroeconomic scenario is based on the national short-term forecast for the years 2002-03, finalised in November 2002. The external assumptions are based on the Commission services' Autumn 2002 forecast of growth picking up gradually in 2002-03. The projections from 2004 onwards are based on the surveys of the longer-term growth potential of the Finnish economy assuming decelerating trend growth in the population of working age and a fall in the participation rate as population ages. In view of the baby boom generation approaching retirement age towards the end of the programme period, these assumptions appear plausible.

3.2 Macroeconomic developments

The short-term macro-economic projections of the programme assume somewhat stronger growth for 2002, compared with the short-term outlook of the 2003 budget proposal of September 2002, and virtually identical growth rates for 2003. The more favourable outlook for 2002 takes account of an upward revision of growth for the first half of 2002. In the second quarter, the Finnish economy returned back to the growth track following a decrease in the fourth quarter of 2001 and in the first quarter of 2002. Particularly exports were buoyant and as domestic demand resumed its growth-supportive role, GDP grew by 2.1% on the quarter. In the third quarter, stockbuilding boosted GDP which grew by 0.5% from the second quarter. On average, output growth is forecast to have accelerated from 0.7% in 2001 to some 1½ % in 2002. Based on the assumption of a recovery of the external contribution to growth, activity should gather momentum reaching a rate of growth of 2.8% in 2003. Towards the later years of the

programme period, however, output growth is estimated to be constrained by the shortages in labour supply and GDP growth is foreseen to abate to around 2½ %.

Recent data point to a slowdown in employment creation. As a consequence, unemployment is set to go up in 2002-03, in spite of an expected pick-up in growth. Furthermore, the unemployment rate remains well above the average for the euro area and the gap appears to be widening in 2003. The labour market trend seems broadly plausible, although the Commission expects a slightly stronger employment creation and thus, unemployment could be marginally lower in 2002-03 compared with the programme estimates.

The programme presents virtually no information on wage developments. It is only briefly noted, that real wages are expected to evolve in line with the average growth in productivity, but figures are presented for labour productivity only. On the basis of collective wage agreements reached in 2002[13], the Commission expects nominal wage growth to accelerate slightly to 3¾ % in 2003 from an estimated 3.3% in 2002. Still, given strong wage moderation for most of the 1990s, the competitive position of the Finnish companies remains relatively good.

HICP inflation fell below the euro area average as from late spring 2002, reflecting fading of external price shocks. Still, excluding the expected negative price shock from the abolition of alcoholic and tobacco duties, the average inflation rate is forecast to hover around 2% throughout the programme period. Prices of private services are expected to be the main driver of inflation. Table 1 compares the macroeconomic forecasts of the programme and the Commission services.

Table 1. Macroeconomic scenario – forecast comparison

Economic Forecasts 2002-2004
(Annual average growth rate, in %)

	2001	2002		2003		2004	
	NA	SP 1)	COM 2)	SP 1)	COM 2)	SP 1)	COM 2)
GDP	0.7	1.6	1.4	2.8	2.8	2.6	3.4
Private consumption	1.1	2.5	2.7	2.5	2.5	2.8	2.6
Exports (Goods & Services)	-2.2	1.9	2.5	4.5	5.7	4.2	6.6
Imports (Goods & Services)	0.1	1.4	1.6	3.2	5.5	3.6	5.9
Gross fixed capital formation	4.0	-0.6	-1.6	0.6	1.5	1.9	4.3
HICP	2.7	2.1	1.9	2.0	1.8	1.0	2.0
Employment growth	1.4	0.2	0.2	-0.1	0.0	0.4	0.8
Unemployment a)	9.1	9.2	9.1	9.4	9.3	8.9	8.9
Budget Surplus (% of GDP)	**4.9**	**3.8**	**3.6**	**2.7**	**3.1**	**2.1**	**3.5**
Debt (% of GDP)	**43.4**	**42.5**	**42.4**	**41.9**	**41.9**	**41.9**	**41.1**

SP = Stability Programme; COM = Commission Autumn forecast; NA = National Accounts
a) % of Labour Force
1) November 2002 2) November 2002

The government projections compare reasonably well with the Commission Autumn forecasts for 2002-03. In 2004, however, the Commission projects GDP growth in line with potential of above 3%, whereas the programme expects growth to lose

[13] A collective wage agreement for the years 2003 and 2004 was concluded in December 2002. It awards increases of nominal wages of 2.9% in 2003 and 2.2% in 2004. Assuming an average wage drift of about 1 percentage point, as in past years, compensation per employee will increase by nearly 4% in 2003 and over 3% in 2004.

momentum, owing to constraints in the labour market and sluggish investment. Overall, the programme appears more cautious with regard to both domestic and external contributions to growth in 2004. In the Commission forecast, investment, in particular, is assumed to markedly accelerate in the face of the stronger external demand.

On the whole, the macroeconomic scenario of the programme appears plausible. Nevertheless, some downside risks should not be neglected. In particular, a prolonged weakness in external demand would be particularly felt in the Finnish knowledge-based and forest industries. Furthermore, if this would translate into sluggish domestic demand, it may lead to higher than expected unemployment. This would be particularly critical, as already in the baseline scenario unemployment is projected to rise. According to the slow-growth scenario (assuming weaker growth by 1 percentage point) the rise in the unemployment rate would accelerate, leading to a jobless rate of about 10% for the whole of the programme period.

4 BUDGETARY TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

4.1 Programme overview

The latest stability programme update confirms the budgetary policy strategy of the previous programme of creating a sizeable surplus in general government finances. According to this strategy, the central government finances should claim a structural surplus in the order of 1½ to 2 % of GDP in the medium-term through pluri-annual spending guidelines. Expenditure control is deemed necessary as tax revenues will face erosion of tax bases and increased tax competition in the near future. Furthermore, regarding government debt, the programme regards it essential that the general government gross debt be reduced significantly in view of the future expenditure pressures stemming from ageing population. In particular, privatisation proceeds should primarily be used to reduce government debt.

Table 2. Comparison of key public finance figures

% of GDP		**2002**	**2003**	**2004**	**2005**	**2006**
Gen. Gov. budget balance	SP 2002	3.8	2.7	2.1	2.6	2.8
	SP 2001	2.6	2.1	2.6		
	COM	3.6	3.1	3.5		
Total Expenditures	SP 2002	47.5	47.1	46.9	46.4	46.1
	SP 2001	47.6	47.0	46.2		
	COM	50.4	49.4	48.3		
Total Revenues	SP 2002	51.3	49.9	49.1	49.0	48.9
	SP 2001	50.2	49.0	48.8		
	COM	54.0	52.5	51.8		
Government gross debt	SP 2002	42.5	41.9	41.9	41.4	40.7
	SP 2001	42.9	43.0	41.8		
	COM	42.4	41.9	41.1		

SP 2002 = Stability Programme update of November 2002
SP 2001 = Stability Programme update of November 2001
COM = Commission Autumn 2002 forecast

The latest programme update estimates the general government surplus to ease markedly, from an estimated 3.8% of GDP in 2002 to 2.1% in 2004. Compared with the previous update, on the other hand, the surplus is seen higher for the years 2002 and 2003, whereas a somewhat (by 0.5 percentage points) lower surplus is forecast for 2004. The current update extends the programme period from 2004 to 2006, and the surplus is projected to rise from 2.1% of GDP in 2004 to 2.8% by 2006.

Regarding government levels, the 2002 programme foresees a *central* government surplus of just under 1% of GDP in 2002[14], down from 2.0% in 2001, and a further decrease to 0.3% in 2003[15]. Moreover, it appears that the projected central government surplus would have been somewhat lower in 2002 without some shifts of corporate tax revenues from 2001 to 2002. The financial position is seen to slip into deficit in 2004-05, before balance should be restored in 2006. The projected net lending of *local governments* has also been revised downwards for virtually every year of the programme period[16]. Local government finances are now expected to slide back into a small deficit during the period 2003-06, whereas legislation adopted in 2001 requires local governments to aim from 2002 onwards for budgetary balance in the medium-term. Finally, the estimated surplus of *social security institutions* has been raised by 0.2–0.4 percentage points to about 3% of GDP for 2002-04 at which level it should remain through the end of the programme period.

In March 2002, the central government revised the medium-term spending limits agreed one year earlier. According to the new guidelines, real expenditure (excluding interest payments) is expected to be frozen between 2003-06. The second supplementary budget proposal for 2003 shows that in 2003 central government finances roughly abide by the limit set by the latest spending ceilings. However, according to the second supplementary budget for 2002, central government expenditure (including interest payments) will exceed the 2001 spending guidelines by 3% in real terms[17].

The spending limits are the primary instrument of the Finnish government to maintain budgetary discipline. Clearly, the very favourable budgetary situation in 2000-01 created some room for additional expenditure. Nevertheless, as there have been repeated overruns of expenditure in the past, the new spending ceilings introduced in March 2002 need to be adhered to, if this policy tool is to remain credible.

The programme includes calculations of the structural balance of government finances. Given the differences on the revenue side, however, the projections are not comparable with the previous programme[18]. The figures presented in the Finnish programme are

[14] Developments of the budget balance of central and local governments in 2000-02 are strongly influenced by the cyclical movements of capital and corporate tax revenues.

[15] Real expenditure of the central government is projected to rise by nearly €1 billion in 2003 above the medium-term target of freezing expenditures at the level of 1999.

[16] The financial position of local governments in 2002 was boosted by transfers of tax receipts; remittances of income taxes raised local government tax revenues by altogether €400 million (0.3% of GDP).

[17] The overrun in 2001 was about 3 ½ %.

[18] Differences appear to emerge from the NAIRU estimates and in particular from the exclusion of the effect on revenue from a rise in share prices in 2000.

fairly close to the estimates by the Commission services, both those using the assumptions of the programme for GDP growth and the government balance (left side of Table 2) as well as those of the Commission services Autumn forecast (right side of Table 2). Estimated potential growth rates of GDP differ only marginally from each other. Due to a slightly larger output gap estimate in the programme, the cyclical component of public finances appears slightly smaller than in the Commission estimates, leading to a lower cyclically adjusted general government balance (CAB) in 2002-04.

Table3. Cyclically-adjusted public finances

	Stability Programme[1)]				**Autumn Forecast*)**[2)]			
	Budget Balance	**GDP growth**	**PF Potential growth**)**	**CAB**)**	**Budget Balance**	**GDP Growth**	**PF Potential growth**	**CAB**
2001	4.9	0.7	3.8	3.7	4.9	0.7	3.8	3.8
2002	3.8	1.6	3.2	3.6	3.6	1.4	3.3	3.7
2003	2.7	2.8	3.0	2.7	3.1	2.8	3.1	3.3
2004	2.1	2.6	3.1	2.4	3.5	3.4	3.2	3.6
2005	2.6	2.5	2.9	3.1				
2006	2.8	2.4	2.6	3.5				

1) The programme present structural balances calculated using the HP-filter method, not the Commission PF-method . This tables presents PF-method estimates by the Commission services based on the SP data.
2) The Commission estimates are based on the PF-method.
*) Commission services Autumn forecast 2002.
**) Commission estimates based on the data of the stability programme of November 2002.

Between 2002-04, the nominal balance is forecast to fall at somewhat faster pace than the cyclically adjusted balance (by 1¾ and 1¼ percentage points of GDP, respectively) and the nominal surplus seems to be reaching a lower trough of about 2% of GDP compared with that of the CAB of some 2½ % in 2004. However, the CAB is estimated to recover more strongly towards the end of the programme period, reaching a level of 3½ % of GDP in 2006, whereas nominal balance is estimated at below 3%. In the absence of any known one-off budgetary measures, the CAB can be taken as being equal to the underlying budget balance.

According to this analysis, the projected decline in the underlying balance by over 1 percentage points of GDP between 2002-04, clearly revealed in both the programme and the Commission estimates (using the programme assumptions), seems to come at a time when the economy should be gathering momentum and when the output gap is on the whole still positive, suggesting a pro-cyclical stance of fiscal policy. Still, with underlying surpluses of at least 2% of GDP, Finland is expected to continue to satisfy the requirements of the SGP over the whole programme period.

4.2 Public finances in 2003

The programme projects the general government surplus to continue to fall, reaching 2.7% of GDP in 2003. This is mostly due to tax revenues, in particular from the corporate sector, falling by 1.2 percentage points of GDP from 2002. Furthermore,

social security contributions are expected to fall owing to rising unemployment. This will trigger a release of funds from the so-called EMU-buffers[19] to prevent a rise in contribution rates. To compensate for the income tax cuts at the central government level, amounting to about 0.3% of GDP[20], the government plans to raise energy and environmental taxes in 2003[21]. Although central government continues to cut income taxes in 2003, the average municipal income tax rate is expected to rise by about ¼ percentage point, thereby partly offsetting the favourable effect of state's tax relief on employment.

The programme expects general government expenditure to be constrained as spending in relation to GDP is expected to fall by 0.4 percentage points of GDP. This rests on the assumption of strict adherence to the central government spending guidelines, of lower investment expenditure by local governments and of lower interest payments on government debt. However, central government transfers to other government levels are expected to rise further, as well as current expenditure of municipalities, and unemployment and health outlays. General government debt is forecast to fall by 0.6 percentage points to 41.9% of GDP in 2003, on account of a substantial primary surplus and higher nominal GDP.

4.3 Targets and adjustment in 2004 and beyond

The updated programme projects a general government surplus of 2.1% of GDP in 2004. From thereon, the surplus should rise gradually to 2.8% by 2006, owing to expenditure restraint, whereas revenues in relation to GDP are forecast to decline somewhat. The fall in the surplus in 2004 will mainly be due to the central government balance slipping into deficit (by some 0.8 percentage points of GDP) from 2003, on account of an erosion of the tax base[22]. Social security contributions to pension funds are set to rise on the back of a reform designed to speed up the pre-funding of the earnings-related pension fund between 2003 and 2013. Furthermore, the programme assumes no further income tax relief from 2004 onwards. In addition to the erosion of the tax base in 2004, tax competition is seen to increase owing to economic integration. Therefore, tax revenue from the corporate sector is assumed to decline over the programme period.

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[19] The funds were motivated by Finland's participation in EMU in 1999. The full buffers in the earnings-related pension scheme correspond to 2½% of the annual payroll in the private sector and in the unemployment insurance fund to annual earnings-related unemployment benefit obligations of an unemployment rate of 3.6%.

[20] Since the submission of the programme, the government supplemented (for the second time) its budget proposal for 2003 by, *inter alia*, additional tax cuts worth €112 million.

[21] See footnote 11.

[22] See footnote 1.

Table 4. Revenue and Expenditure Ratios

% of GDP	ESA code	Year 2002	Year 2003	Year 2004	Year 2005	Year 2006	Chg.* 02-06
Components of revenues							
1.1. Taxes	D2+D5	32.4	31.2	30.2	30.0	29.8	-2.6
1.2. Social contributions	D61	12.2	12.0	12.2	12.3	12.5	0.2
1.3. Other		6.8	6.7	6.7	6.7	6.7	0.0
1. Total receipts	**ESA**	**51.3**	**49.9**	**49.1**	**49.0**	**48.9**	**-2.4**
Components of expenditures							
2.1. Collective consumption	P32	7.7	7.7	7.6	7.6	7.6	-0.1
2.2. Social transfers	D63, D62	16.8	16.6	16.6	16.5	16.4	-0.4
2.3. Interest payments	D41	2.5	2.4	2.3	2.2	2.1	-0.4
2.4. Subsidies	D3	1.5	1.5	1.5	1.5	1.5	-0.1
2.5. Gross fixed capital formation	P51	2.5	2.3	2.2	2.2	2.1	-0.4
2.6. Other		16.5	16.6	16.6	16.5	16.6	0.0
2. Total expenditures	**ESA**	**47.5**	**47.1**	**46.9**	**46.4**	**46.1**	**-1.4**

* = percentage points change (calculated from non-rounded values)

According to the programme, the government is expected to continue a strategy of expenditure restraint over the period 2004-06. The expenditure in relation to GDP should fall by some 0.8 percentage points by 2006 from 2004. This is based on the assumption of virtually freezing central government real expenditure at the level of 2003[23], agreed by the spending limits in March 2002[24]. Given that certain new spending measures have been introduced after March 2002 (not specified in the programme), the government will need to finance each additional spending either by expenditure cuts or by improving the efficiency of the central government functions in order to achieve this goal. Strict adherence to central government expenditure ceilings is important also in view of the age-related expenditure pressures, since local governments seem to build up deficits in their financial position[25] drifting, thus, further away from the target set in 2001 by legislation requiring local government finances to remain close to balance within a three-year period. It has to be pointed out, though, that the estimated fall in both revenue and expenditure ratios are based on a relatively cautious estimate on nominal GDP for 2004-06 and the ratios could even reduce further in case of more robust economic activity.

[23] Which is projected to exceed the government target of keeping the real expenditure at the level of 1999 by about €1 billion.

[24] Government has stated that central government budgetary expenditure will be monitored excluding the cost of debt redemption. According to this strategy, expenditure savings arising from reduced debt servicing will not be diverted to other spending. These actions were successful in the 1990`s; after 1994 central government real expenditure decreased annually until 2000. In 2001 and 2002 real primary expenditure is estimated to have increased annually by over 3%.

[25] Deficits are projected for 2003-06 in local government finances.

4.4 Sensitivity analysis

The programme includes four sensitivity scenarios for developments of public finances: low and high GDP growth scenarios (+/- 1 percentage points annual deviation from the baseline) as well as low and high interest rate scenarios (+/- 1 pps). General government finances are expected to post a noticeable surplus even in the low growth scenario and general government gross debt would still be left significantly below the 60% threshold. As could be expected, growth constitutes a greater risk to public finances than interest rates. The Commission estimates that slower trend GDP growth by one percentage point p.a. leads to a decrease in general government net lending by almost 0.7 percentage points[26].

Using the baseline macroeconomic scenario of the programme, the Commission services have carried out a sensitivity analysis allowing for a change in potential output growth over the programme period implying, that the underlying government balance is also allowed to change. The results confirm the picture given by the sensitivity analysis of the programme. The general government financial position stands a good chance to comply with the requirement of "close to balance or in surplus" in the medium-term, since even in the worse-case scenario, the underlying government surplus would reach some 1¾ %[27]. The estimated fall in the structural surplus by some 1½ percentage points of GDP between 2002-04 in the Commission's worse-case scenario, is on a par with the results of the programme under the baseline scenario. To conclude, the projected budget surpluses in the 2002 programme update appear more than sufficient to provide the necessary safety margin against breaching the 3% reference value of the SGP in the event of normal cyclical fluctuations.

4.5 Debt ratio

The general government gross debt ratio is forecast to remain well below 60% of GDP and on a downward path virtually throughout the programme period. The programme projects debt to fall from an estimated 42.5% of GDP in 2002 to 40.7% by 2006. Compared with the previous programme update, the current programme projects the debt to GDP ratio to be about ¾ percentage points lower for 2002-03, in spite of the outcome in 2001 turned out to be 0.7 percentage points higher (at 43.4% of GDP). In 2004, the gross debt is estimated to increase at the pace of nominal GDP leaving the debt ratio unchanged. In 2005-06, a downward trend in the debt ratio should resume. The stabilisation of the debt ratio in 2004 is partly due to the inflation difference of about 0.6 percentage points from the previous programme and partly to lower primary surplus compared with 2003. The estimated 2 percentage point decline in the debt ratio between 2002 and 2006 might have been even larger had the central government spending guidelines been fully respected in 2001-02. According to the programme, the decline in the gross debt ratio is slowed by significant financial transactions, in particular the ongoing diversification of social security institutions' assets away from central government bonds. It cannot be excluded, however, given the amount of government debt held by the social security sector, that the portfolio shifts of the pension funds might be faster than expected in the programme[28], and the fall of the

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[26] Commission services estimate it at 0.66.

[27] In the worse-case scenario, the cyclically adjusted budgetary surplus would go down to some 1¾ % of GDP in 2004, from where it would rise to about 2½ % by 2006.

[28] See footnote 3.

gross debt ratio could slow down even more over the period. Still, the government gross debt ratio should remain below the 60% ceiling for the whole period of the programme under any reasonable scenario. In addition, it appears that the financial assets in the public sector exceed its gross debt owing to the partial pre-funding of pensions.

5 THE SUSTAINABILITY OF PUBLIC FINANCES

The updated stability programme contains a detailed section on the sustainability of public finances, on the basis of national projections for public expenditures and revenues up to 2050. They suggest that age-related expenditures will increase by some 6 percentage points of GDP between 2005 and 2050: revenues are also projected to increase by some 2 percentage points of GDP over the same period.

It is first necessary to consider whether current budget polices and the medium-term target can ensure that the SGP will continue to be respected in the future in the light of the budgetary implications of ageing populations. The Commission calculations verify the conclusion of the programme that public finances in Finland are in a good position to meet the budgetary consequences of an ageing population (see table 7 of Annex 2 to this note). This is largely due to the sustained running of a budget surplus which is leading to a fast pace of debt reduction.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. Even though the budget surplus is set to decline somewhat over the time horizon of the stability programme, gross debt will continue to fall rapidly, and there is an explicit policy goal of running down gross debt levels continuously over the coming two decades. The sustainability of public finances is supported by a pension system that is to a large extent pre-funded (the market value of which was some 51% of GDP in 2001). Further reforms are planned, *inter alia*, for pension provisions in the public sector, early-retirement schemes, incentives to encourage older workers to remain in the labour force, and mechanisms to adjust pension entitlements in line with changes in life expectancy.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. The most immediate challenge will be to finalise the planned reforms of the pension system according to the time frame indicated in the stability programme. A longer term challenge may stem from the fact that the projected sustainability of public finances is based on an assumption of a high tax ratio of some 50% of GDP in coming decades. It is up to each Member State to determine its tax ratio in accordance with its needs and preferences. However, the projected tax ratio is high relative to other industrialised countries and the desirability of maintaining such high tax ratios over the very long-run could be called into question by the increasing mobility of production factors (and consequently tax bases), in times of globalisation. A comparison of the development of *net* debt and budget balance according to two different scenarios, a "programme scenario" and a "2002 situation scenario" can be found in Annex 2 and table 7.

6 STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

A specific recommendation in the 2002 BEPGs for Finland, noted in the programme, was to continue with determination the ongoing process of pension reform. Therefore, it is welcome that the programme presents a significant agreement reached in September 2002 to reform the private sector pension system[29]. Moreover, according to the government, a reform of the public sector pension system will also be reached in the near future. A reform of the unemployment insurance system was agreed in late 2001. All these measures should help to keep control over expenditure in coming years. Only few reform measures will be introduced as of 1 January 2003 while main reforms should be adopted as of 1 January 2005 and some as late as in 2009. Therefore, phasing-in periods for some of the measures appear rather long, implying that the financial benefits of these reforms will largely accrue only after 2010. In addition, the programme presents measures to improve the financial balance of local governments[30].

The programme assumes privatisation proceeds to amount to about 2.1 % of GDP over the programme period. This is somewhat higher than estimated in the previous programme. Earlier already, the government has decided that the bulk of privatisation proceeds would be allocated to debt redemption as well as to research and development.

As for the more short-term challenges, the government's key economic objective is to raise the employment ratio to close to 70% of the working age population, and in particular to encourage the continued employment of older workers. Moreover, unemployment in Finland remains well above the level in other EU Member States, with the gap projected to grow further in 2003. The programme sets out the government's intentions of cutting further income tax and social security contribution in 2003, to strengthen active labour market measures and to seek greater labour market flexibility[31]. Still, it appears that the active labour market measures taken so far, as well as those designed to reduce the tax wedge on labour income will not suffice to reduce the hard core of structural unemployment.

Regarding product and capital markets, the measures taken so far have been actions in the right direction and the Finnish economy has gradually become more open in recent years. Further reforms in financial markets have been pursued, particularly to secure

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[29] Measures include, *inter alia*, an introduction of the flexible retirement age of 62-68, accompanied by higher accrual rates of pension rights for the later years in work; a rise of the part-time pension age from 56 to 58 years, accompanied by a reduced accrual rate of the part-time salary; a gradual abolition of the unemployment pension scheme and the abolition of the individual early (disability) retirement scheme; pension benefits will be calculated on the basis of wages during the whole work career with an improved indexation of wages (a hybrid index with a weight of 80% to a wage index and of 20% to a price index); the annual accrual rate will be 1.5% up to the age of 52 years,1.9% in the age range of 53 to 62 years, 4.5% in the age range of 63 to 68 years: from the age of 53 onwards the employee pension contribution will be 30% higher than for those under 53; the so-called lifetime coefficient will be introduced as of 2009, i.e. a mechanism that adjusts the level of the pension to the expected lifetime.

[30] E.g. revenue of local governments has been made less sensitive to cyclical fluctuations and better budget monitoring is being developed.

[31] E.g. taxes on labour have been reduced, the quality of ALMPs will be improved and efforts to prevent exclusion from the labour market will be intensified.

more effective supervision and to enhance the stability of markets. To secure the quality and availability of public services, especially in social welfare and health care, in coming years, the structure of public service provision production needs to be overhauled. Measures aimed to boost the effectiveness of public administration are encouraged.

The structural reform measures presented in the programme are clearly a step in the right direction, in particular with respect to improving the longer-term sustainability of public finances overall and strengthening the predictability of local government finances.

7 OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

The updated programme foresees a decline in the general government surplus from 4.9% of GDP in 2001 to 2.1% in 2004, due to a normalisation of corporate and capital tax revenues. In subsequent years, the surplus is expected to resume an upward trend and rise to 2.8% of GDP by 2006. The short-term fall in the surplus ratio is caused by a weakening of central government finances which are estimated to even slip into deficit as from 2004. Furthermore, the local government financial balance seems to resume its customary deficit in 2003. In fact, according to the programme, the general government financial surplus in 2004-06 rests solely on the surplus of the social security funds and, moreover, on that of the earnings-related pension funds preparing for financial pressures stemming from an ageing population. In spite of the expected deficit in central and local government finances, the underlying government surplus is estimated at 2% of GDP, or higher, for the whole programme period.

General government debt is forecast to decline throughout the programme period, with the exception of 2004, with the fall amounting to 1.8 percentage points between 2002 and 2006. Eventually, the debt ratio is seen at 40.7% of GDP in 2006, remaining well below the 60% of GDP reference value in any reasonable growth scenario. In all, the projected path of the government balance both in nominal and underlying terms and of the government debt confirms that public finances in Finland continue to fully respect the requirements of the Stability and Growth Pact throughout the programme period.

ANNEX 1 – Summary tables from the 2002 updated stability programme

Table 1. Growth and associated factors

	ESA Code	Year 2001	Year[32] 2002	Year 2003	Year[33] 2004	Year 2005	Year 2006
GDP *growth* at *constant* market prices (7+8+9)	B1g	0.7	1.6	2.8	2.6	2.5	2.4
GDP *level* at *current* market prices	B1g	136.0	140.5	146.2	151.5	157.6	163.7
GDP deflator		3.0	1.6	1.3	1.0	1.5	1.4
HICP change		2.7	2.1	2.0	1.0	2.0	2.0
Employment growth[34]		1.4	0.2	-0.1	0.4	0.4	0.3
Labour productivity growth [35]		-0.6	1.8	2.9	2.2	2.1	2.1
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure	P3	1.1	2.5	2.5	2.8	2.6	2.4
2. Government consumption expenditure	P3	2.1	2.4	1.4	0.9	0.9	0.9
3. Gross fixed capital formation	P51	4.0	-0.6	0.6	1.9	1.9	1.6
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+ P53	0.1	-0.3	0.1	0.0	0.0	0.0
5. Exports of goods and services	P6	-2.2	1.9	4.5	4.2	4.0	4.0
6. Imports of goods and services	P7	0.1	1.4	3.2	3.6	3.5	3.4
Contribution to GDP growth							
7. Final domestic demand (1+2+3)		1.8	1.6	1.6	1.9	1.8	1.6
8. Change in inventories and net acquisition of valuables	P52+ P53	0.1	-0.3	0.1	0.0	0.0	0.0
9. External balance of goods and services (5-6)	B11	-1.1	0.4	1.0	0.8	0.7	0.8
Basic assumptions							
Short-term interest rate[36] (annual average)		4.2	3.3	2.8	3.2	n.a	n.a
Long-term interest rate (annual average)		5.0	4.8	4.4	4.7	n.a	n.a
USD/€exchange rate (annual average)		0.9	0.9	1.0	1.0	n.a	n.a
World excluding EU,GDP growth		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
EU-15 GDP growth		1.5	1.0	2.1	2.7	n.a	n.a
Growth of relevant foreign markets		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World import volumes, excluding EU		-1.7	3.2	6.8	7.4	n.a	n.a
Oil prices		23.6	25.5	24.1	22.5	n.a	n.a

[32] Forecasts
[33] Trend values or period averages
[34] National accounts definition
[35] Growth of GDP at market prices per person employed at constant prices
[36] Purely technical assumptions

Table 2. General government budgetary developments

% of GDP	ESA code	2001	2002	2003	2004	2005	2006
Net lending (B9) by sub-sectors							
1. General government	S13	4.9	3.8	2.7	2.1	2.6	2.8
2. Central government	S1311	2.0	0.9	0.3	-0.5	-0.2	0.0
3. State government	S1312						
4. Local government	S1313	-0.4	0.0	-0.4	-0.3	-0.4	-0.4
5. Social security funds	S1314	3.3	2.9	2.8	3.0	3.1	3.2
General government (S13)							
6. Total receipts	ESA	52.0	51.3	49.9	49.1	49.0	48.9
7. Total expenditures	ESA	47.1	47.5	47.1	46.9	46.4	46.1
8. Budget balance	B9	4.9	3.8	2.7	2.1	2.6	2.8
9. Net interest payments		0.7	0.4	0.1	0.2	0.0	-0.1
10. Primary balance		5.6	4.2	2.9	2.3	2.6	2.7
Components of revenues							
11. Taxes	D2+D5	32.6	32.4	31.2	30.2	30.0	29.8
12. Social contributions	D61	12.5	12.2	12.0	12.2	12.3	12.5
13. Other		6.9	6.8	6.7	6.7	6.7	6.7
14. Total receipts	ESA	52.0	51.3	49.9	49.1	49.0	48.9
Components of expenditures							
15. Collective consumption	P32	7.6	7.7	7.7	7.6	7.6	7.6
16. Social transfers	D63, D62	13.5	13.8	13.9	13.9	13.9	14.0
17. Interest payments	D41	2.7	2.5	2.4	2.3	2.2	2.1
18. Subsidies	D3	1.5	1.5	1.5	1.5	1.5	1.5
19. Gross fixed capital formation	P51	2.6	2.5	2.3	2.2	2.2	2.1
20. Other		2.7	2.7	2.7	2.7	2.6	2.6
21. Total expenditures	ESA	47.1	30.7	30.5	46.9	46.4	46.1

Table 3. General government debt developments

% of GDP	ESA code	2001	2002	2003	2004		2004
Gross debt level		43.4	42.5	41.9	41.9	41.4	40.7
Change in gross debt		-0.6	-0.9	-0.6	0.0	-0.5	-0.7
Contributions to change in gross debt							
Primary balance		-5.6	-4.2	-2.9	-2.3	-2.6	-2.7
Interest payments	D41	0.7	0.4	0.1	0.2	0.0	-0.1
Nominal GDP growth	B1g	-1.6	-1.4	-1.7	-1.5	-1.6	-1.6
Stock-flow adjustment		5.9	4.3	3.8	3.6	3.8	3.7
Of which: Privatisation receipts		0.0	-0.9	-0.3	-0.3	-0.3	-0.3
p.m. implicit interest rate on debt		5.9	5.8	5.8	5.4	5.5	5.3

Table 4. Cyclical developments[37]

% of GDP	ESA Code	2001	2002	2003	2004	2005	2006
1. GDP growth at constant prices	B1g	0.7	1.6	2.8	2.6	2.5	2.4
2. Actual balance	B9	4.9	3.8	2.7	2.1	2.6	2.8
3. Interest payments	D41	2.7	2.5	2.4	2.3	2.2	2.1
4. Potential GDP growth[38]		3.2	3.0	2.9	2.8	2.7	2.7
5. Output gap[39]		2.1	0.5	0.3	0.2	-0.1	-0.1
6. Cyclical budgetary component		1.3	0.3	0.2	0.1	0.0	-0.1
7. Cyclically-adjusted balance (2-6)		3.7	*3.5*	2.5	2.0	2.6	2.9
8. Cyclically-adjusted primary balance (7-3)		6.3	6.0	4.9	4.3	4.8	5.0

Table 5. Divergence from previous update

% of GDP	ESA Code	2001	2002	2003	2004	2005	2006
GDP growth	B1g						
previous update		0.6	1.6	2.7	3.0		
latest update		0.7	1.6	2.8	2.6	2.5	2.4
Difference		0.1	0.0	0.1	-0.4		
Actual budget balance	B9						
previous update		4.7	2.6	2.1	2.6		
latest update		4.9	3.8	2.7	2.1	2.6	2.8
Difference		0.2	1.2	0.6	-0.5		
Gross debt levels							
previous update		42.7	42.9	43.0	41.8		
latest update		43.4	42.5	41.9	41.9	41.4	40.7
Difference		0.7	-0.4	-1.1	0.1		

Table 6. Long-term sustainability of public finances [40]

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	46.7	45.6	47.6	50.4	52.0	53.1
Old age pensions[41]	10.7	11.7	13.3	14.7	14.6	14.4
Health care (including care for the elderly)	6.2	6.8	7.4	8.3	9.0	9.1
Interest payments	2.8	2.1	1.9	2.4	3.4	4.6
Total revenues	53.7	49.6	50.5	51.3	51.4	51.6
of which: from pensions contributions	7.2	8.3	9.3	9.3	9.3	9.2
Assumptions						
Labour productivity growth	2.8	2.2	1.8	1.8	1.8	1.8
Real GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total participation rates (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate	9.8	7.0	7.0	7.0	7.0	7.0

[37] Member States can fill in lines 4-8 using either own figures or Commission figures.
[38] Trend GDP, % change.
[39] Deviation from GDP trend, % change.
[40] Information in this table, if provided, should be updated at least every 3 years.
[41] Employment pensions, which do not include central government pensions, which amounted to 1.8% of GDP in 2000.

ANNEX 2 - The quantitative assessment of the sustainability of public finances

This is the second assessment of the sustainability of Finnish public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.[42]
The Finnish stability programme contains national budgetary projections for public expenditures and revenues up to 2050, and are based on the demographic projection of Eurostat used by the EPC. They take on board the recent pension and unemployment security reforms, which would result in a more favourable evolution of the employment rate compared with the assumptions used by the EPC.
In assessing the sustainability of public finances under the SGP, the Commission has to draw a balance between using national projection which may be more comprehensive and up to date, and the need to ensure comparability across countries. The table below presents the budgetary data used by the Commission in running the sustainability indicators, and several points are worth noting.

- the Commission did use the budgetary projections provided by the Finnish authorities for age-related public expenditures, including those expenditure items not yet projected by the EPC;

- in the absence of analysis of the EPC on the impact of ageing populations on tax revenues, the Commission did not use the projections for revenues included in the Finnish programme. Instead, the Commission assumed that the tax ratio remains constant as a share of GDP at the level indicated in the programme for 2006;

- Finland has large financial assets in pension funds which can be used to meet future expenditure needed, and thus there is a very large gap between the measure of gross and net debt. This has been taken on board by the Commission.

The table below presents the net debt and budget balance development according to two different scenarios, a “programme scenario” and a “2002 situation scenario”. The ”programme scenario” is calculated on the following basis:

- the projections for age-related expenditures come from the stability programme;

- government revenues are held constant at the ratio projected for 2006;

- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The “2002 situation scenario” is based on the budgetary data for 2002 in the programme. It is assumed that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allows one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.
Public finances appear to be sustainable under both scenarios.

[42] ‘How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years’, Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

Table 7. Quantitative indicators of the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	change
Total age-related spending	18,0	18,5	20,7	23,0	23,6	23,5	5,5
Pensions	11,4	11,7	13,3	14,7	14,6	14,4	3,0
Health care	4,8	4,9	5,2	5,6	5,7	5,8	1,0
Other age related expenditures	1,8	1,9	2,2	2,7	3,3	3,3	1,5
*Total non age-related spending**	26,0						
Total revenues	48,9	0,0	0,0	0,0	0,0	0,0	-48,9

*constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	change
Programme scenario							
Debt*	-16,8	-24,9	-42,5	-48,1	-45,0	-39,0	-22,2
Net borrowing	2,8	2,9	2,5	1,1	0,8	0,9	-1,9
2002 situation scenario							
Debt*	-22,2	-42,0	-92,0	-135,3	-177,3	-224,5	-202,2
Net borrowing	5,5	6,4	7,4	7,9	10,0	12,8	7,3

*net of financial assets

Tax gaps	T1*	T2**	T3***
programme scenario	-0,6	-1,1	-0,5
2002 situation scenario	-3,2	-3,7	-0,8

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt ratio at the end of the period: 4.1

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

***It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: 2002 Update of Finnish Stability programme, Commission calculations